

Internal Revenue Service

**memorandum**

CC:TL-N-6235-90 TL-N-8213-90

RPSubin Br2

date: SEP 28 1990

to: District Counsel, Buffalo  
Attn: Randall P. Andreozzi

CC:BUF

from: Assistant Chief Counsel (Tax Litigation)

CC:TL

subject: Request for Tax Litigation Advice  
I.R.C. § 7701(e)  
[REDACTED]

This responds to your June 29, 1990, tax litigation advice request.

ISSUES<sup>1</sup>

1. Is it the government's position that I.R.C. § 7701(e) is a codification of Xerox Corporation v. United States, 656 F.2d 659 (Ct. Cl. 1981)?
2. Are any of the factors listed in section 7701(e) to be given more weight in the evaluation process than others?

Conclusion

1. It is the government's position that section 7701(e) is an "extension" of Xerox, but not a "codification."
2. Some factors listed in section 7701(e) are to be given more weight in the evaluation process than others, but the weights to be allocated to each depend on the facts and circumstances of each case.

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<sup>1</sup>Your memorandum originally contained three issues. Mr. Andreozzi of your office informed Mr. Subin of our office that the third issue should be retracted.

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## DISCUSSION

I.R.C. § 38 provides a credit against income tax liability for a taxpayer's investment in certain depreciable property used in its trade or business.

In general, section § 48(a)(1) defines "Section 38 property" as tangible personal property used by a taxpayer in its trade or business with respect to which depreciation (or amortization in lieu of depreciation) was allowable and having a useful life (determined as of the time the property was placed in service) of 3 years or more.

Section 48(a)(5), as amended by Section 31(b) of the Deficit Reduction Act of 1984, provides as follows in pertinent part:

(5) Property used by governmental units or foreign persons or entities. --

(A) In General. --Property used--

(i) by the United States, any State or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing, or

\* \* \*

Shall not be treated as section 38 property.

Treas. Reg. § 1.48-1(k) relates to property used by governmental units in section 48(a)(5) and reads in pertinent part:

Property used by governmental units. The term "section 38 property" does not include property used by the United States, any State (including the District of Columbia) or political subdivision thereof. \* \* \*

The term "property used by the United States, etc." means (1) property owned by any such governmental unit (whether or not leased to another person), and (2) property leased to any such governmental unit. Thus, for example, a data processing or copying machine which is leased to any such governmental unit would be considered as property used by such

governmental unit. Property leased by another person to any such governmental unit or leased by such governmental unit to another person is not Section 38 property to either the lessor or the lessees, \* \* \*

This paragraph shall not apply to property leased on a casual or short-term basis to any such governmental unit.

Section 7701(e) of the Code, as added by Section 31(b) of the Deficit Reduction Act of 1984, provides as follows:

(e) Treatment of Certain Contracts for Providing Services, Etc.--For purposes of Chapter 1--

(1) In general.--A contract which purports to be a service contract shall be treated as a lease of property if such contract is properly treated as a lease of property, taking into account all relevant factors including whether or not--

- (A) the service recipient is in physical possession of the property,
- (B) the service recipient controls the property,
- (C) the service recipient has a significant economic or possessory interest in the property,
- (D) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract,
- (E) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and
- (F) the total contract price does not substantially exceed the rental value of the property for the contract period.

Section 31(g)(1) of the Deficit Reduction Act of 1984 provides that the above Code sections apply to property placed in service by the taxpayer after May 23, 1983, or to property placed in service by the taxpayer on or before May 23, 1983, if the lease to the tax exempt entity was entered into after May 23, 1983.

As you are aware, in Xerox the Court of Claims held that the taxpayer was entitled to the investment tax credit on the grounds that copying machines placed on the premises of governmental units and tax exempt organizations under rental agreements were not leased to them, but were supplied as an integral part of a service contract. In Xerox, the court examined all the facts and circumstances and enumerated nine factors it found determinative of a service contract and not a lease. 656 F.2d 675-7.

However, the addition of Code § 7701(e) by the Deficit Reduction Act of 1984 represents an "extension" of Xerox and a prospective change in controlling legal principles. As set forth above, this Code section enumerates six factors to be evaluated in determining whether a transaction is to be treated as a service arrangement or a lease of property. The legislative history of section 7701(e) emphasizes that the determination of lease versus service arrangement is to be made on the basis of all relevant factors, including, but not limited to, the six statutory factors. See Rep. No. 169, Vol. II, 98th Cong., 2d Sess., 139 (1984); General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., 59 (Comm. Print 1984).

In Smith v. Commissioner, T.C. Memo. 1989-318 respondent stated "section 7701(e) codifies the former case law focus on the economic substance of a transaction." Brief at 27. Respondent also stated "A review of these factors, which really are a codification of prior precedents...". Brief at 29. Although the word "codification" was used on brief in Smith, respondent also stated in Smith that "recent changes in the Internal Revenue Code have added additional factors to be considered in determining whether an agreement is a lease or a service agreement." Brief at 26. The brief goes on to introduce section 7701(e).

Thus, it is the Service's position that section 7701(e) incorporates the factors of Xerox into the Code section but also mandates looking at other facts and circumstances. That is, section 7701(e) is an "extension" of the Xerox case but not a "codification" of Xerox. Consequently, facts similar to Xerox would not compel the same result as in Xerox because under section 7701(e) other factors must also be addressed and considered. This conclusion was informally coordinated with the Income Tax and Accounting Division.

Issue 2

The legislative history behind section 7701(e) reveals that "all relevant factors be taken into account, including but not limited to" those announced in Code § 7701(e). General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., 59 (Comm. Print 1984). Furthermore,

Although each of the relevant factors must be considered, a particular factor or factors may be insignificant in the context of any given case. Similarly, because the test for determining whether a service contract should be treated as a lease is inherently factual, the presence or absence of any single factor may not be dispositive in every case.

General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., 60 (Comm. Print 1984).

The committee then lists 4 examples to illustrate when something called a service contract will or will not be respected as such.

Reviewing these examples together with the rest of the legislative history lead to the conclusion that some factors of section 7701(e) are to be given more weight in the appropriate fact pattern. In other words, the facts and circumstances of each case will dictate which factors should be given more weight.

Conclusion

For the reasons stated above, the Service's position is that section 7701(e) is an "extension" of [REDACTED] but not a "codification." Furthermore, some factors listed in section 7701(e) are to be given more weight in the evaluation process than others, but the weights to be allocated to each depend on the facts and circumstances of each case.

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